

Chapter 5

The private lender and the loan broker

This chapter discusses the relationship between the private lender and the loan broker.

Use of the lender disclosure statement

A broker arranging a loan with a private lender must disclose the **priority** of the lender's trust deed relative to other liens against the real estate.

However, if a loan is arranged with an institutional lender, the broker need not provide the institutional lender with a lender's disclosure statement. [Calif. Business and Professions Code §10232.4(b)]

Also, if a loan is made by a broker while acting as both the lender (principal) and as an agent for the buyer or seller in a real estate sale, no disclosure statement to the lender-broker is required, as he would merely be advising himself. [B & P C §10230]

Consider a broker who completes a **lender's disclosure statement** with loan information received from a borrower (e.g., value of the property securing the loan, credit and financial information about the borrower, etc.). The statement is presented to prospective private lenders. [See **first tuesday** Form 326]

Each lender's disclosure statement also states whether the lender's trust deed will be junior to existing first and second trust deeds on the borrower's real estate.

Here, the broker has complied with his duty to disclose to prospective lenders all aspects of the proposed loan transaction, including the priority of each lender's trust deed relative to existing encumbrances on the real estate that will secure the loan. [B & P C §10232.4(a)]

In another example, an owner retains a broker to arrange two loans from separate lenders secured by the same property.

When negotiating the loans with different private lenders, the broker must disclose to each lender that the property will be encumbered by another trust deed lien not yet recorded. The priority of the respective new trust deed liens is to be disclosed in each lender's disclosure statement prepared by the broker. [B & P C §10232.5(a)(6)]

Disclose credit and financial information supplied on the borrower

A broker or sales agent negotiating the placement of a real estate loan or the sale of a trust deed note to a private lender or trust deed investor must disclose information about the prospective borrower's identity, occupation, employment, income and credit data as represented to the broker or sales agent by the prospective borrower. This is best accomplished through the use of a disclosure form. [See **first tuesday** Form 326]

For example, an owner of real estate contacts a loan broker to arrange a loan he needs.

An annual operating (income/expenses) statement and a net worth statement (balance sheet), called *financial statements*, are completed by the owner and handed to the broker.

The financial statements indicate to the broker that the owner has a moderate income, and does not have the ability to make payments on the loan sought.

Meanwhile, the broker requests and receives a credit report which indicates an excellent payment history and credit rating. However, when presenting his loan package to the lender, the broker fails to hand over the owner's financial statements or advise the lender the borrower has insufficient income to justify the loan amount and rate. The lender is informed only of the owner's "clean" credit history.

The lender makes the loan and the owner soon defaults due to insufficient income to cover his payment obligation.

However, a broker has a duty as a licensee to advise the lender, even if the lender is not his client, about the owner's income and expenses as disclosed by the owner or otherwise known to the broker, even though the owner's credit report indicates no past credit problems.

Before a lender decides to make a loan, information given by a borrower is used by the lender to objectively determine the future likelihood of the owner defaulting on the loan, and thus the risk undertaken and the interest rate, due date and security required to cover the risk of loss on a default.

A lender has a right to obtain sufficient facts from the borrower to make an informed decision on the risk of default it undertakes on making or allowing the assumption of the loan. [**Wellenkamp v. Bank of America** (1978) 21 C3d 943]

Private lenders rely on brokers to obtain information necessary to make a decision to lend based on the borrower's ability to comply with the terms of the loan. Private lenders frequently do not have the same resources as institutional lenders to determine the borrower's creditworthiness. Thus, private lenders employ brokers for the purpose of analyzing the risk of loss presented by the loan — and to pass on information received from the borrower and reporting agencies. [**Dawn Investment Co., Inc. v. Superior Court of Los Angeles County** (1982) 30 C3d 695]

The borrower's ability to repay

A broker or sales agent may not hand false or misleading information to real estate lenders and trust deed investors about a borrower's or owner's ability to repay a real estate loan.

For example, a buyer retains a broker to arrange a loan. As part of his loan package, the broker investigates the buyer's credit history through a credit reporting agency. The credit report informs the broker the buyer is inclined to make timely payments on his obligations.

Next, the broker analyzes information in financial statements provided by the buyer regarding his income, expenses and assets (operating and balance sheets).

Both the credit report and financial statements indicate a good credit rating and substantial income and assets.

The broker, attempting to verify information in the buyer's financial statements, discovers the buyer has significant additional expenses and loans he has not disclosed.

The broker has *reason to believe* the undisclosed expenses and loans will interfere with the buyer's ability to make his payments on the loan and increase the lender's risk of loss.

However, the broker does not tell the lender about the additional expenses and loans. Instead, the broker limits his disclosures to the buyer's good credit rating, high income, and substantial assets in the report produced by the buyer.

The lender makes the loan. Before the loan is repaid, the buyer declares bankruptcy and the lender suffers a loss on the loan.

The broker's failure to inform the lender about the buyer's undisclosed expenses and loans known to the broker, which if known to the lender might alter the lender's analysis of the loan, subjects the broker to discipline by the Department of Real Estate (DRE) on a complaint by the lender.

Also, the lender can recover his loan losses from the broker since the broker knew adverse credit information existed and intentionally omitted advising the lender about the significant adverse conditions, called *material facts*.

The borrower's loan history

A broker and his sales agents must disclose to real estate lenders and trust deed investors their knowledge of the borrower's:

- ability to make payments on the note; and
- propensity to maintain the property under the trust deed.

Disclosures regarding the borrower include the borrower's loan payment and property maintenance history and any delinquencies or defaults on the trust deed note being sold, and whether the borrower has a bankruptcy history.

For example, a borrower who owns a business retains a real estate broker to arrange a loan with a lender to be secured by the business, its inventory and his leasehold interest in the premises occupied by the business.

The broker investigates and analyzes the borrower's:

- credit history to determine the borrower's payment history;
- net worth to analyze the borrower's assets and liquidity; and
- income and expenses to calculate ratios on the borrower's capacity to pay.

Also, the broker contacts some of the borrower's past business associates for information on the borrower's management of his business and financial affairs, as well as care of the premises he occupied.

The broker discovers the borrower is currently in bankruptcy but will be released before the loan is originated. The pending bankruptcy is not included in the credit report.

The broker tells the lender only about the financial data obtained through the reports and statements. The pendency of the bankruptcy is not disclosed since the borrower will be released from bankruptcy prior to recording the new trust deed and it will not affect the title insurance for the loan.

The lender makes the loan which records after the release from bankruptcy. Later, the borrower reopens the bankruptcy and lists the new loan.

The lender claims he never would have made the loan to the borrower, or certainly would have charged a premium rate for the additional risk, had he known the borrower was, or had been within a few years, in bankruptcy when the loan was arranged.

Here, the broker was duty bound, as an agent in the loan transaction, to advise the lender of the borrower's pending bankruptcy while arranging the loan — even though the lender was not his client. The information is pertinent to an analysis of the borrower's ability to manage his affairs and the rate of interest to be charged to cover any additional risk of loss imposed on the lender by the borrower's level of care and management of his business.

Accurately disclose the condition and value of secured property

When soliciting a lender or arranging a real estate loan, a broker will accurately represent the market value, the physical condition and the size of the property securing the loan.

For example, a private lender retains a loan broker to arrange the investment of funds in second trust deed loans.

The loan broker hires an independent real estate appraiser to evaluate a property which is to secure a loan to be arranged for the private lender.

The appraiser submits an appraisal report on the property to the broker. The report states the value of the property to be much higher than the property's actual value.

The broker relies on the appraisal report and does not further investigate the property's value nor confirm the findings of the report.

The private lender agrees to make a loan secured by a second trust deed on the property based on its appraised value in the report obtained by the loan broker.

Later, the owner of the secured real estate defaults on the loan. The private lender's trust deed is wiped out when the first trust deed holder forecloses on the property. Recovery is not available under the now unsecured note due to the financial condition of the maker.

The private lender seeks to recover the loss of his investment from the loan broker because of the appraiser's misrepresentation of the value of the property.

The loan broker claims the private lender cannot hold him liable and must look to the appraiser for any recovery since the appraiser was an independent contractor retained by the loan broker.

Is the loan broker liable for the private lender's losses due to the appraiser's faulty appraisal of the property?

Yes! A loan broker has an agency duty to accurately represent the value of the property to the private lender.

A broker cannot delegate to an appraiser the duty to accurately ascertain the value of the property that will be or is the security for the loan. [**Barry v. Raskov** (1991) 232 CA3d 447]

The broker in *Barry* seeks to excuse himself of liability for the appraiser's faulty report on the property's value, claiming the issue of who caused the loss is between the appraiser and the lender.

However, the agency duty the broker owes to his principal, the private lender, to establish value cannot be *assigned to others* to avoid liability for any error in the performance of the duty owed. Further, the broker's responsibility for accurately advising the private lender about the value of the property which

will secure the proposed loan cannot be shifted to others by use of disclaimers of responsibility, or advisory instructions to consult with other (more) professional advisors.

However, *indemnity* may be available to the broker to cover his liability if the broker acted in reliance on another individual's professional advice, such as an appraiser, certified public accountant (CPA), home inspector or attorney. [**Home Budget Loans, Inc. v. Jacoby and Meyers Law Offices** (1989) 207 CA3d 1277]

Also, a broker has the option of contracting for appraisal reports with an appraiser who carries errors and omissions insurance. Thus insured, the broker has a source of recovery under indemnification for the false information passed on to the client.

Further, the broker can monitor the appraiser's activities, with leverage over the appraiser's work through incentives such as repeat business and refusal to pay for unacceptable reports. [Barry, *supra*]

A broker's failure to accurately represent the value of property securing a loan subjects him to liability for money damages, and the possible suspension or revocation of his license by the DRE. [B & P C §§10176(a), 10177(g)]

Terms of loan originated or sold

The terms of a loan being originated or sold by a broker must be disclosed to the prospective private lender or individual trust deed investor in a lender's disclosure statement.

Loan terms include the amount of the loan, payment schedules, payoff provisions, and any lender/investor transactional costs. [See **first tuesday** Form 326]

Also, a broker selling a trust deed must include the payment terms of the trust deed investment in the disclosure statement handed to the investor. [B & PC §10232.5]

A broker arranging a loan must disclose in the statement to the lender any loan proceeds the broker will retain. [B & P C §10232.5(a)(9)]

Also, a broker arranging loans or selling trust deeds must account to the lender or investor for any loan payments he receives.